Risk Management Does Not Begin With Asset Allocation - Asset Allocation is a Function of Security Selection Informed by Risk Management

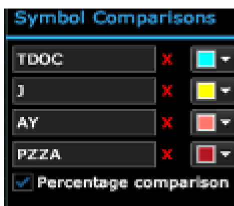
August 17, 2021

Successful investing is 100% about the future. Unfortunately, the future is inherently opaque and difficult to forecast with any precision. So how are some professional investors able to overcome the future's inherent uncertainty while others do not? First, most professional investors do not try! They are far too worried about being wrong in the short-term because they have capitulated to the fallacy that they must best a passive 100% fully invested zero-cost index over relatively short increments of time to be considered successful. Secondly, those who do try to navigate the opaqueness of the future make the fatal error of using the past as their primary guide.

Seven Summits Capital believes that the key to successful equity investing is focusing on a company's prospects through its publicly traded equities. This focus is trained on factors, such as management, capital structure, and the competitive landscape. We believe that one must think more like a CEO, an investment banker, or a venture capitalist than a stock trader. One must attempt to determine a company's current intrinsic value and then extrapolate how that intrinsic value will change according to various forecasts extending at least five years into the future. Only after going through this exercise can an investor build confidence in their investment thesis on a particular company and its stock. Focusing on companies, as opposed to stock prices, harkens back to investment luminaries such as Philip Fischer, the late legendary investor, who once said, "the stock market is filled with individuals who know the price of everything, but the value of nothing."

Virtually every individual security held in Seven Summits Capital client portfolios is a product of the process as described above. With seasoned portfolios (5-plus years), the success of this process becomes evident as significant unrealized capital gains in many of the longer-held securities begin to reflect the success of our approach. Such a process requires confidence and patience. There are no short-cuts when using forecasts to select securities other than the introduction of luck to generate substantial capital appreciation through stock ownership. Through our process, chance only comes into play regarding the timing. Luck can cut both ways, good luck in timing can accelerate capital appreciation, and bad luck can lengthen the realization of expected returns. We expect our investments to require time for the price to close the gap with intrinsic value; however, occasionally, we are pleasantly surprised when an investment's previously unrecognized value gap closes much quicker than expected.

We know that markets are fickle and move in very unexpected ways. Thus, we do not count on rapid capital appreciation with our investments, but we certainly do not complain when it happens. The recent market has rewarded many of our clients with such rapid capital appreciation within our universe of actively held stocks. Some of our holdings that have experienced market-beating capital appreciation over the last 24 months are Teledoc, Jacobs Engineering, Atlantica Sustainable Yield Corp, and Papa Johns. Factors such as the result of the Presidential election and the unexpected advent of the COVID-19 pandemic played an important role in accelerating the returns of these holdings. For example, we originally entered our first Teledoc positions nearly six months before the COVID-19 pandemic. The stock significantly benefited from the pandemic response as Teledoc's business model became a strategic imperative for many healthcare providers.



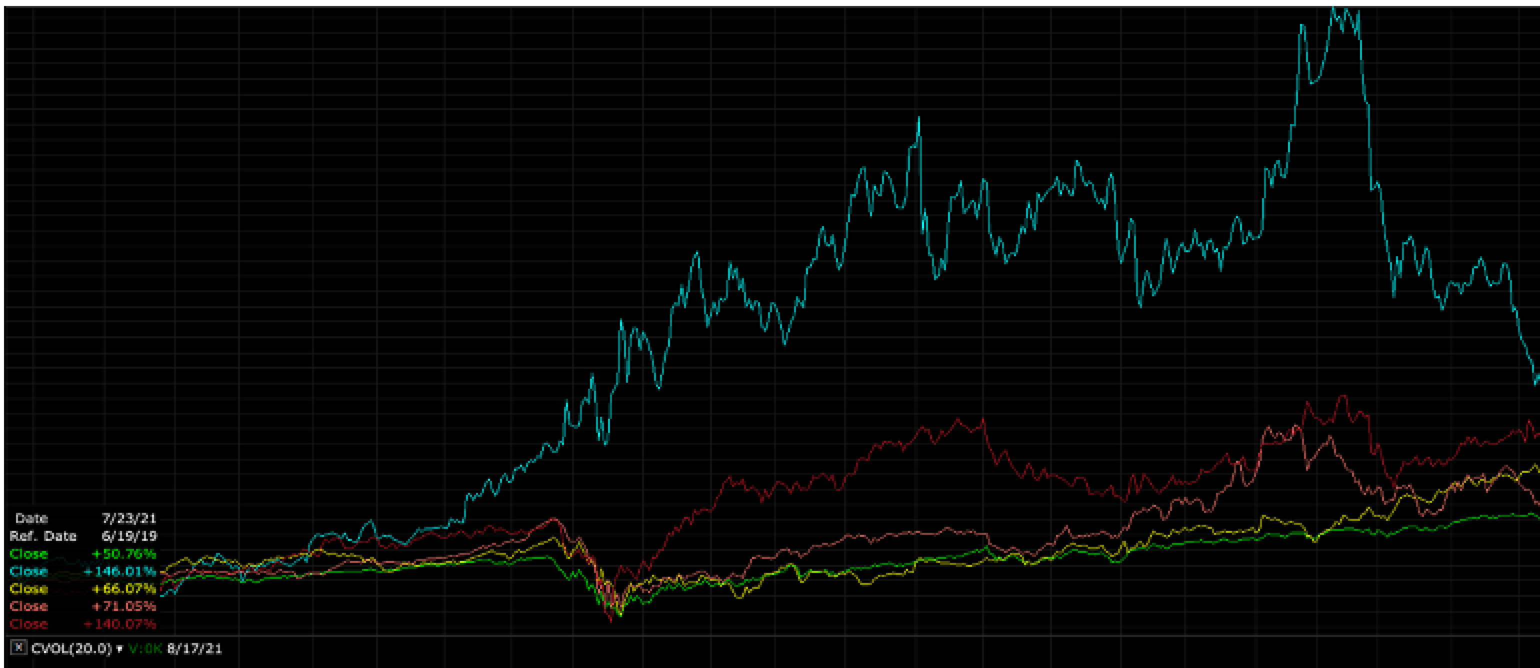
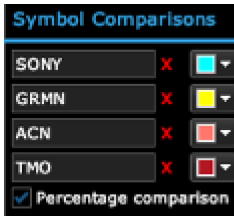
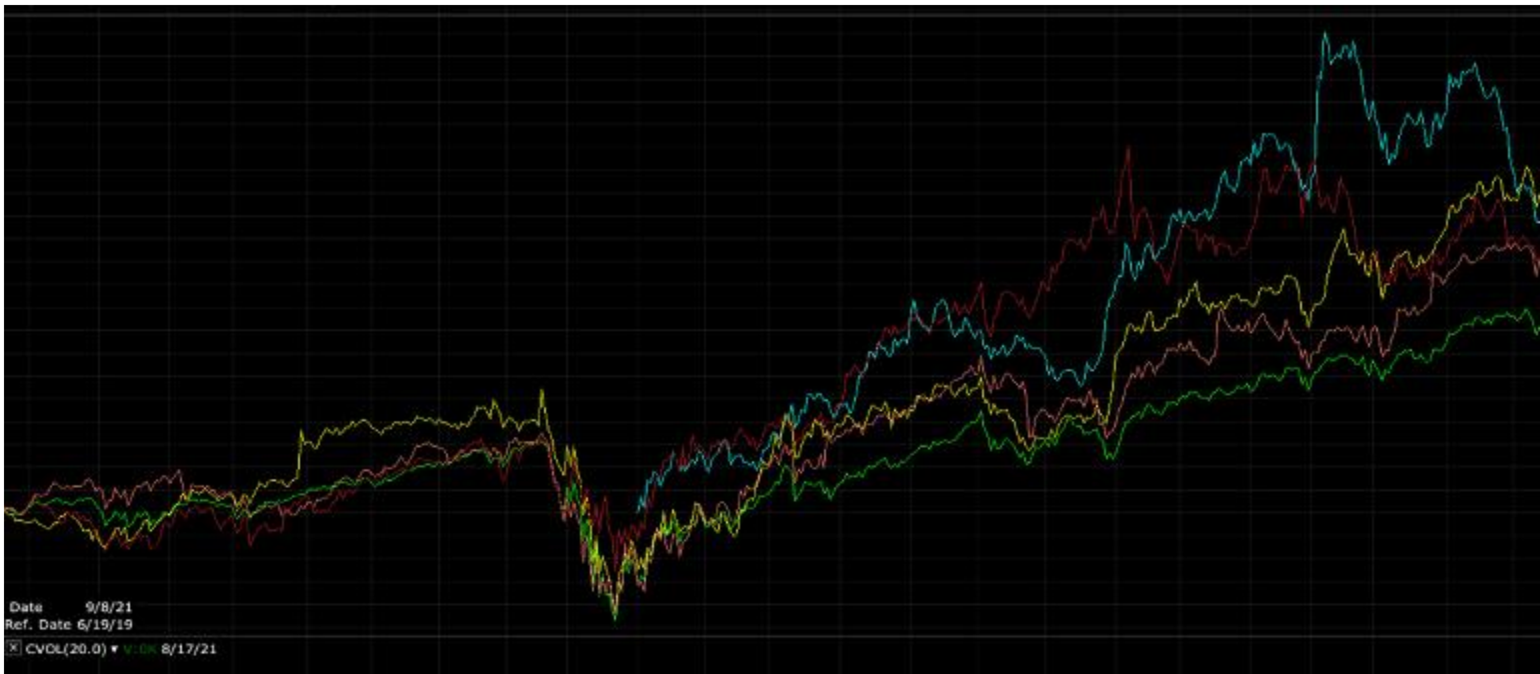


Chart by QUODD

We welcome these short-term winners; however, we are most proud of our longer-held investments, which are currently producing returns that far exceed the market averages over periods exceeding five years. A few examples of stocks that we have had in our universe of actively held stocks for over five years which have produced such returns to date are Sony(SONY), Garmin(GRMN), Accenture(CAN), and Thermal Fisher(TMO).





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Right now, we are not only happy to hold many of our recent winners, but we are also always looking for new opportunities that can be the big wealth builders of the next five years. For example, we currently believe that Dermtech(DMTK), GoodRx(GDRX), Spotify(SPOT), AT&T(T), Cavco(CVCO), Twist Bioscience(TWST), and Unity Software(U) can be meaningful contributors to many client portfolios. ***The customized portfolio management process that Seven Summits Capital utilizes, one that eschews rigid modeling, dictates that not all portfolios and clients will own the same securities. Thus, not all client portfolios will hold the specific securities discussed above. Many factors dictate if and when a portfolio includes particular securities. Some of the most common factors are the portfolio size, which determines how many securities it will own, whether the portfolio regularly receives new funds, the taxable status of the portfolio, and the clients' unique investment objectives and risk tolerance.***

We work very hard to find mismatches between market pricing and real-world fundamental value, often called intrinsic value. This approach is commonly referred to as "bottom-up" stock selection. Bottom-up, in contrast to top-down, means that we do not use the broad market or macro-economic data to inform us where to invest. Instead, we simply search for companies that are mispriced relative to the public market pricing. We do this because public markets are driven by price discovery, which provides us great investment opportunities.

I often get asked if I think that the stock market is over-valued or under-valued. I appreciate that this is a natural question for someone in my profession. However, I do not typically have any original thoughts about the broad markets. I regularly read various analyses on the quantitative exercise of forecasting average annualized market returns over the next ten years. Such forecasts are interesting, but whether potential market returns over the next ten years are likely to be above or below historical averages does not directly impact how we select securities for our client portfolios. What I am sure of is that the more the public markets become price agnostic and driven by flows into index funds or social media influences like Reddit's Wall Street Bets community or stock pumpers on Twitter, the more opportunities there will be to find disconnects between stock prices and company intrinsic values.

Managing real risks instead of the statistical risk as measured by volatility means looking forward and recognizing what allocation decisions can result in permanent capital loss. Looking forward, I am confident that most "quality" fixed income assets are nothing more than a bet on future interest rates. Generically bond values are purely mathematically driven, and the most influential element of the valuation equation for quality bonds are interest rates. Suppose an investor has forty percent of their nest egg invested in a diversified quality bond fund such as an aggregate or total return bond fund or ETF. In that case, that investor is making a significant bet that interest rates will remain at current levels or decline. With quality bond yields sitting at 1.25% to 2.50%, a one-half percent increase in interest rates will wipe out over two years of income. A one percent increase in interest rates will cost the investor nearly five years of income. Thus, if interest rates rise over several years, the absolute total return in a broad quality bond allocation will be negative. If inflation is factored into the equation, the real negative return could be twice the absolute return.

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.

Curt R. Stauffer

President & CIO

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Disclosure:

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

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