

High & To The Right Instead of Zig vs. Zag

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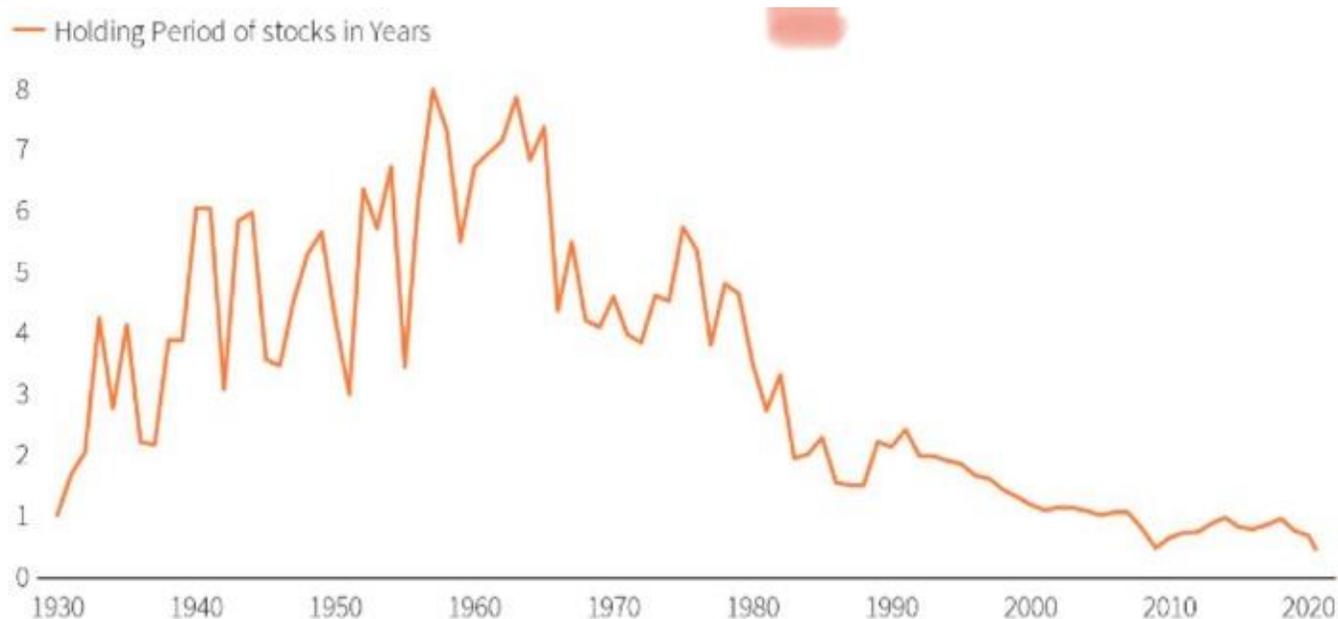


I have heard many people refer to stock investing as gambling. If you turn on CNBC, you are likely to hear hosts ask their guests how they are going to “play” a particular upcoming event or data release. Most retail investors learn about investing from watching investing programs on TV or, of late, from social media posts. Both television and social media have one common objective, attracting viewers and “clicks.” It is evident that if you want to attract views or clicks, you need a “hook.” For investor-related content, that “hook” is most effective when it engenders urgency, excitement, or fear. Over time, investing-oriented programming has evolved from Louis Rukeyser’s Wall Street Week, where he would convene a panel of seasoned investors who discussed the concepts of value, investing in stocks for the long-term, and risks that might impact the businesses, their earnings, and ultimately the appreciation potential of their stocks. Such the discussion of values, investing for the long-term, and business fundamentals are the exceptions to the rule. Today, much of financial media is geared to trading (e.g. CNBC’s Fast Money), option bets (CNBC’s Options Action), and playing the stock price impact of short-term data releases and macro risks such as economic data and geopolitical events (Hedgeye.com).

Many defenders of trading would say the markets allow me to trade stocks; my goal is simply to try to make money, and trading creates liquidity on the stock exchanges. One can certainly view markets and trading this way; however, this is not the way markets were designed to work. Markets have changed significantly over my lifetime. We increasingly seem to live during a time when technology has put access to casino games and sports betting at our fingertips. Regarding the gamification of stock trading, I argue that what seems like innocent trading is not without serious ramifications. Unlike betting on the chance that your favorite NFL team kicks a field goal in the fourth quarter of next Sunday’s game, where the volume of betting does not change the

probability of a field goal being kicked in that quarter, the trading of stocks direction sets the prices of stocks. Thus, traders are not passive participants; in aggregate, trading is a dependent variable, not an independent variable, when it comes to the direction of the price of the stock.

The following chart dramatically illustrates the impact of trading on the hold period for stocks:



Note: Holding periods measured by value of stocks divided by turnover
Source: NYSE, Refinitiv

At Seven Summits Capital, we manage investment portfolios for clients who engage us to consistently execute a long-term investment strategy, which is the antithesis of short-term trading. We are not attempting to scalp profits from day-to-day, week-to-week, or month-to-month stock price gyrations. Sadly, as this chart illustrates, we continue to invest in a market environment where most are playing the losing game of short-term trading. It has been well documented that a tiny percentage of professional short-term traders achieve a profitable outcome, let alone attain profits commensurate with the risk.

On June 28th, 2022, Motley Fool, the well-known online stock recommendation service, posted an article titled [Day Trading Definition: Why it Differs From Investing](#), in which they wrote the following: "It's fair to say that day trading and gambling are very similar. The dictionary definition of gambling is "the practice of risking money or other stakes in a game or bet." When you place a day trade, you're betting that the random price movements of a particular stock will trend in the direction you want. In the same way that expert poker players study and practice relentlessly to excel at the game, the few successful day traders (who may be at institutions) tend to be extremely well-versed in how markets move in the short term. If a novice poker player were to challenge a table of experts, he or she may conceivably win one or two hands but would almost certainly lose money overall. While day trading is not precisely the same as gambling, one thing remains true about the practice: Most of the time, it is not profitable." For a quarter of a century, I have spent virtually every trading day following the markets, the economy, the geopolitical landscape, and at least 100 individual stocks. I can confidently say that short-term trading is virtually impossible to do successfully in any consistent manner.

The truth is that the stock market is a market of stocks. The majority of those stocks present a substandard risk-return proposition for investors. A small percentage of those stocks will substantially outperform over a long period; think Apple, Amazon, and Microsoft. Outside of the poor risk-return stocks and the small percentage of stellar performers, there are many very good companies whose stocks are priced very attractively because the companies are misunderstood, under-appreciated, or overlooked. As active managers, we strive to assemble a portfolio where the majority of holdings fall into the category of very good companies that, for a myriad of possible reasons, have stocks that offer an attractive risk-return opportunity. Over time we believe that we will end up owning a few stellar long-term performers and, unfortunately, a few substandard holdings, with the understanding that a stock that appreciates 500% over several years will more than offset a substandard holding which declines 80% before we exit that position.

Having the temperament to effectively manage an individual stock portfolio is rare because stocks can be highly volatile in the short term, and the long-term rewards of owning stocks can take much longer than most investors have the patience to realize. Ben Carlson, CFA, whom I regularly read, publishes an online blog called “A Wealth Of Commonsense.” He wrote in his March 7, 2021, blog titled, Owning Individual Stocks vs. Owning the Market, “Yes, buying individual stocks offers the potential for greater gains but it also opens you up to all sorts of psychological pitfalls that don’t necessarily apply when owning the entire stock market. Portfolio management is so much harder when picking individual stocks, especially in a concentrated manner. Wonderful gains can turn into terrifying losses in an instant, leaving you with more questions than answers.” Our clients hire us because they are astute enough to know that individual stocks offer superior return potential compared to the “average of all stocks” market returns, but they understand that they either do not have the time to manage such a portfolio or the temperament to keep emotions out of investment decision-making.

In the Carlson blog mentioned above, he talked about what an equity investor needs to expect and how investors, who want to experience the outsized returns available through the long-term ownership of stocks, need to think when stocks experience periods of frightening losses. He wrote on these topics: “Whether you’re investing in an index fund or individual stocks and you’re still saving money, you want stocks to fall like this on occasion. If you have a steady income and, more importantly, a steady savings rate, these buying opportunities are your friend. **The problem for many investors these days is they only believe in their stocks when they’re rising. If you don’t believe in those same stocks when they’re falling, you have no business owning them over the long haul.** Could these same stocks that have fallen 30-40% fall even more? Certainly. When owning individual stocks, you have to expect these types of losses even more often than the overall market.”

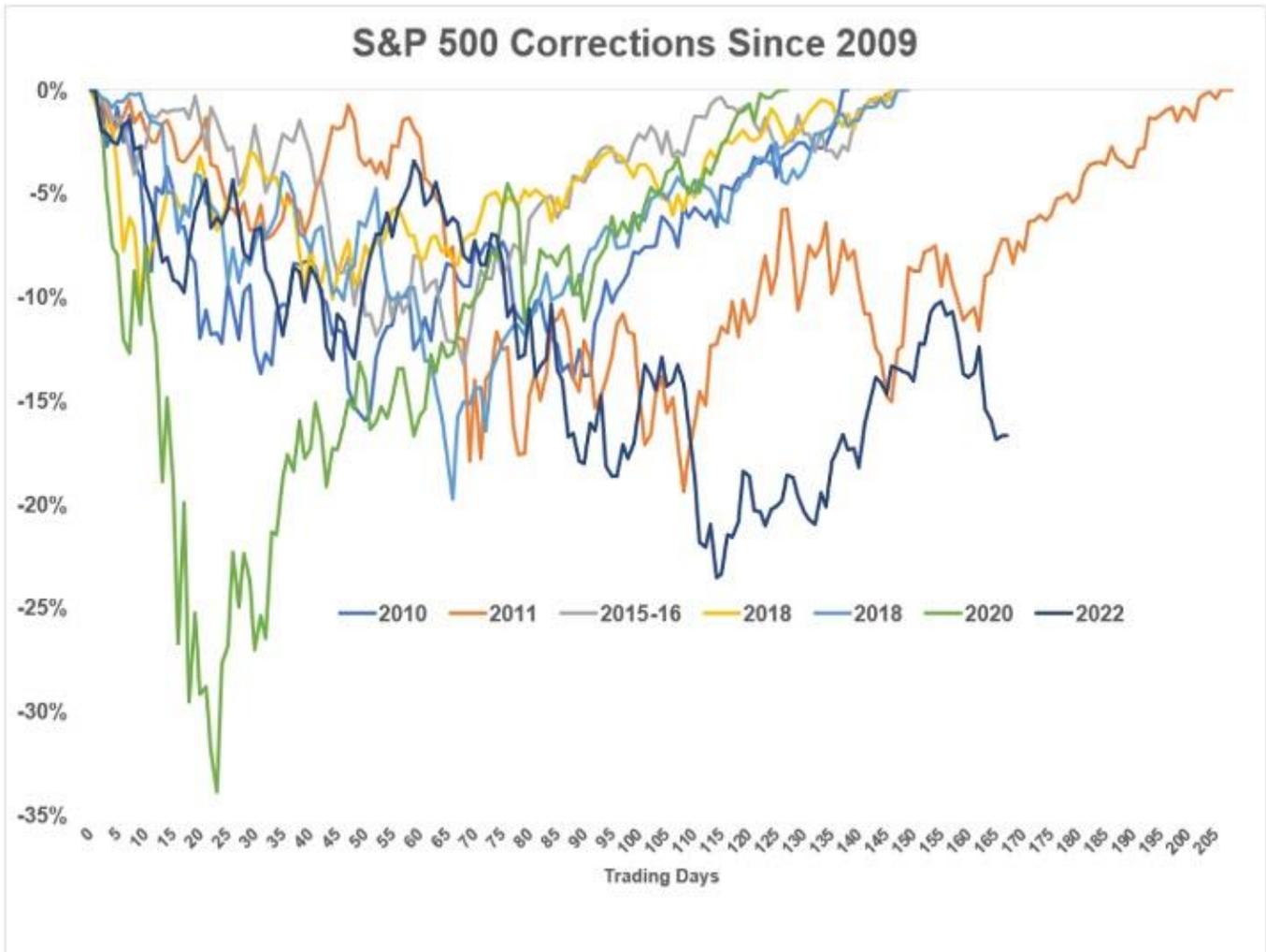
When an investor asks a trader during periods of heightened volatility in the markets whether “everything is going to be all right,” the trader will inherently have an action plan (stop loss orders, options hedging strategy, or simply sitting on cash) and the investor will feel better because the trader is doing something. During the same period of volatility, when an investor asks a long-term asset manager whether everything is going to be all right, the asset manager will say something akin to this will pass; it always has and then reflects on market history to reassure the nervous investor. An experienced long-term asset manager will state what he or she is doing with a portfolio to best position it for the eventual market recovery.

For investors who are invested in individual stocks, there is a lifetime of wisdom in the following Warren Buffett quote: *“Only buy something that you’d be perfectly happy to hold if the market shut down for ten years.”*

I will end this month’s commentary with a few more words from Ben Carlson’s latest blog, published September 2, 2022, titled It’s OK to be Bearish But It is Not OK to Stay Bearish. He wrote: “I don’t really see the need to be bullish or bearish as a long-term investor because I expect to see up markets, down markets, sideways markets, and everything in-between. Instead of going back and forth between being bullish or bearish, I prefer to remain calm-ish. We already know stocks are going to be volatile. Why should you care about market fluctuations if you know they will not last forever?” Bear markets and sharp corrections in the stock

market are very hard for investors who get comfort from certainty and become highly anxious when the illusion of certainty is shattered by falling stock prices.

In Ben Carlson’s latest blog, he included the following chart of the many stock market corrections that we all survived over the last 13 years:



What do all of these stock price corrections have in common? They all end higher and to the right!! Additionally, these stock price correction periods significantly vary in duration. Thus, we do not know when this significant drop in stock prices will bottom and march higher and the right, but we have good reasons to be confident that this downturn will end and move higher and to the right.

Ben Carlson discusses investors’ emotional need for certainty in the September 2, 2020 blog. He writes: “successful long-term investing comes from letting go of the desire to pretend like you know what’s going to happen all of the time. If you don’t need the spend the money in the near-term, you’re going to have to become comfortable with seeing the value of your portfolio go down at times.”

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Disclosure:

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