Hiking is to Summiting Like Trading is to Professional Investing

Curt R. Stauffer
December 6, 2022

The 2022 Bear Market and extreme price moves associated with many stocks have prompted investors to question maintaining a long-term outlook when choosing which securities to hold in a portfolio. I have discussed in recent commentaries how Bear Markets weigh on investor psychology resulting in heightened risk aversion and short-term reactionary behavior. As professional investors (not traders), we are not only long-term fundamental investors during the good times; our process and principles around security selection and portfolio construction remain the same when market cycles enter periods of pessimism and sharp price corrections.

When I began my career as a professional money manager, the Director of Trust & Investments who hired me away from commercial banking clarified one thing. He had heard that I was successful with my personal and family investment accounts. He congratulated me on my success and promptly told me that professional investing required an entirely different mindset.

Every portfolio management and Chief Investment Officer role I have had was in an environment where the investment process utilized active management versus passive asset allocation. Active management denotes an investment management process that incorporates a discipline that emphasizes alpha over beta. Beta is simply the component of an investment portfolio's return tied directly to the risk, volatility, and return of the broad asset class being measured. Alpha is the aspect of a portfolio's return derived from factors other than the beta component. All public security portfolios will exhibit volatility and produce returns that are a combination of beta and alpha.

Analytically, portfolios can be measured to determine their "active share," or how much of a portfolio's performance is attributed to active management versus systematic beta. The calculations estimate how different the portfolio is regarding sector exposure, industry exposure, and individual security selection compared to the applicable benchmark index. Active portfolio management does not mean that securities are "actively" traded. Active management means that the portfolio manager makes decisions to buy, sell or hold securities that differentiate the portfolio from its benchmark in a meaningful manner. To achieve maximum Alpha, a portfolio would have a very large "active share" and behave significantly differently than its benchmark. Regarding Alpha, the late Peter L. Bernstein, investor, professor, author, and editor of the Journal of Modern Portfolio Management, said

"Managers do not create large alpha by being conventional. They do so by taking the risk of being wrong and alone."

The concepts of alpha and beta are analytical. To be successful as a professional investor, both the analytical concepts and the emotional trappings caused by market reactions need to be understood and managed. The period, now going on three years since the beginning of the COVID-19 global pandemic began, has been a graduate-level education in behavioral finance, both in terms of greed and fear. The most effective way to protect against the mistakes driven by greed and fear emotions when investing is to see security prices relative to a longer-term value framework centered on the intrinsic value of enterprises. One of my most quoted investment luminaries, Howard Marks of Oaktree Capital, wrote in his latest commentary titled **What Matters**, "In the short term, security prices are highly susceptible to random and exogenous events that can swamp the impact of fundamental events. **Macro events and the ups and downs of companies' near-term fortunes are unpredictable and not necessarily indicative of – or relevant to – companies' long-term prospects. So little attention should be paid to them.** For example, companies often deliberately reduce current earnings by investing in the future of their businesses; thus, low reported earnings can imply high future earnings, not continued low earnings. To know the difference, you must have an in-depth understanding of the company." Our clients know we are entirely aligned with Howard Marks on this subject. We love discussing companies, addressable markets, competition, innovation, opportunities, and management execution. However, when it comes to explaining the gyrations of stock prices, we are often as perplexed as anyone else, but we do not dwell on not being able to explain the unexplainable. We could fake it and turn to technical mumbo jumbo, such as 200-day moving averages, Fibonacci levels, or other stock price pseudo-science, but that is not our focus.

Warren Buffett has said that investing is "simple, but hard." Professional investing is simple if viewed the way we view it, focused on the intrinsic value derived from discounting future expected cash flows available to the investor in the form of distributions or reinvestment over a time horizon measured in years and decades, not in days, months, or quarters. But to stay focused on the simple, one must analyze the underlying enterprises, understand a company's competitive advantages, and recognize the risks to successful execution. However, the most challenging facet of professional investing is adhering to tenants of what is simple in the face of inevitable short-term price fluctuations that Howard Marks warns should be paid little attention to. Price fluctuations can evoke strong emotions of either greed or fear. Those emotions are a professional money manager's greatest enemy because they can shift focus from simple to virtually impossible, which is short-term trading to amplify the satisfaction that accompanies strong upward price moves or avoid the anxiety and fear associated with short-term price drops.

When are current prices important to a long-term investor? The answer is another aspect of investing that is simple but hard. When current prices rise to a level significantly above a rational range of fair values for a company's stock, otherwise pulling forward future expected appreciation, these types of price moves should trigger either reducing a portfolio position weighting or even reallocating the funds invested in a particular over-priced company to one that is deemed to be fairly priced or underpriced. The same principle applies to the downside. When a company's stock drops significantly for reasons not tied to a deterioration of long-term fundamentals, this drop likely provides an opportunity to increase the future expected return of that particular portfolio holding by buying more shares at what would be deemed to be a very attractive price relative to the long-term intrinsic value. Both of these buy and sell decisions can be very hard to execute if an investor allows emotion to enter into the equation because the actions are contrary to further near-term appreciation for the rising stock and contrary to protection against further near-term losses for the falling stock.

The bottom line is that a long-term professional investor must learn how to operate in a market environment dominated by transactional participants who are inherently short-term price speculators. Investing in a system that subjects you to a constant drumbeat of short-termism and price speculation is very challenging. Our unwillingness to let market price action dictate our process is not stubbornness; it is our experience of navigating some of the worst market selloffs in history that have notably occurred over the last 25 years.

As we move into 2023 and beyond, we will be able to better put the challenging year of 2022 in perspective. At this time of year, it is customary to reflect on what we are thankful for and approach the future with optimism. This year should be no different. We are excited to put 2022 behind us and look forward to the new year. As investors, we see many reasons to be optimistic about 2023 and beyond.

The team at Seven Summits Capital and Redstone Capital wishes everyone a healthy and joyful holiday season!

Curt R. Stauffer

President & CIO

Seven Summits Capital

Disclosure:

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

The views and opinions expressed are for informational and educational purposes only as of the date of writing and may change at any time based on market or other conditions and may not come to pass. This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities, and should not be considered specific legal, investment, or tax advice. The information provided does not take into account the specific objectives, financial situation, or particular needs of any specific person. All investments carry a certain degree of risk, and there is no assurance that an investment will provide positive performance over any period of time. The information and data contained herein were obtained from sources we believe to be reliable, but it has not been independently verified. Past performance is no guarantee of future results. References to market indices do not represent investible securities.

Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus provides a balanced analysis of the investment risks and benefits. Read it carefully before you invest.