

Market Commentary Fourth Quarter 2023

The recent performance of investment markets reinforces the precept that a successful approach to investing won't remain successful forever. Events in 2022 and 2023 humbled and, in some cases, forced out of business outstanding investment firms that had been successful for years. While it's true that the performance of Magnificent Seven stocks—Apple, Microsoft, Google parent Alphabet, Amazon.com, Nvidia, Meta Platforms (formerly, Facebook), and Tesla—accounted for much of the U.S. stock market's recent rise, that dominance is unlikely to persist.

We can learn from the Nifty 50 stocks that soared and crashed in the 1970s. Economists Jeff Fesenmaier and Gary Smith found that, "... with the spectacular exception of Wal-Mart, the glamour stocks that were pushed to relatively high P/E ratios in the early 1970s did substantially worse than the market, in both the short and long run."¹ My takeaway from that example is that today's winners aren't guaranteed to be the winners of tomorrow. The Magnificent Seven could fall out of favor for any number of reasons. I suspect that people will sell those stocks not because of short-term weakness but rather due to a rotation enabled by tax-loss harvesting from losses in other stocks.

The Magnificent Seven's current dominance contradicts what many consider the first principles

of investing. For example, many investors believe that they will be rewarded by paying reasonable prices for businesses that are not appreciated by others—a belief that the Magnificent Seven's performance has so far defied. They also believe stocks will struggle if the Federal Reserve raises rates, as it did in 2023. The Fed's boost of interest rates suggested that 2023 should have been a disaster for the stock market. Yet, those beliefs didn't pay off. Perhaps they weren't truly first principles. Or possibly, the natural order has evolved into a deeper paradigm.

First principles are ideas that can't be boiled down further. As Wall Street guru Shane Parrish of Farnam Street explains in *The Great Mental Models*, "[reasoning from first principles is]...a tool to help clarify complicated problems by separating the underlying ideas or facts from any assumptions based on them."² However, as he says, "First principles do not provide a checklist of things that will always be true; our knowledge of first principles changes as we understand more."³

Perhaps what investors have thought of as first principles needs to be refined. Parrish sees first principles thinking as a way to "blow past inaccurate assumptions" through a process of asking questions.⁴ I'm using first principles thinking to dig deeper into what drives successful investing.

On a related note, I'm also intrigued by second-order thinking, which considers impacts beyond the immediate results of any action. "Being aware of second-order consequences and using them to guide your decision-making may mean the short term is less spectacular," says Parrish, "but the payoffs for the long term can be enormous."⁵ That's a tradeoff I'm willing to make as I seek investments on your behalf. I also appreciate that, as Parrish says, "Second-order thinking can help you avert problems and anticipate problems that you can then address in advance."⁶ It's quite possible that we may find investable opportunities in second-order effects that others have not anticipated.

The importance of second-order thinking relates to my thoughts about artificial intelligence (AI). Many people are swept up in enthusiasm for AI. Sure, it can do great things, but what is the long-term outlook? Theoretical physicist Stephen Hawking has said that AI will initially be owned by whoever develops it. However, over the longer term, the question is: Can AI be controlled?⁷ Will individual companies down the line be able to harness the potential benefits of AI?

Although I continue to search for new opportunities, I have made some changes in client portfolios aside from tax-loss harvesting, adding to portfolio duration and buying back positions we earlier sold or trimmed in order to take profits. We also added an investment in a specific sector that we have

been waiting on for the right price. Client portfolios remain fully invested, even portfolios with significant inflows.

Because bond prices generally rise as interest rates fall, clients' bond holdings have benefited from the decline in interest rates that I predicted in my last quarterly letter. The 10-year U.S. Treasury index went from a rate of 3.5% in April to over 5% in October to 3.9% as I write this letter.

I think that interest rates could come down further in 2024, with some bounces up and down. The decline would be due to positive surprises with inflation. Walmart's CEO said in November, "... we may be managing through a period of deflation in the months to come."⁸ Costco's CEO foresees, "Bigger deflation ... due to lower freight costs."⁹ Rent increases are slowing, and the price of goods could decline. In the U.S., we've already seen a dramatic spike and fall in the price of eggs. The average price of one dozen eggs in November was \$2.14, down from a peak of \$4.82 in January 2023.¹⁰

As always, thank you for the trust you have placed in me and in 7Summit Advisors. We work hard to earn that trust each day.

Sincerely yours,

Li Chang

¹"The Nifty-Fifty Re-Revisited," p. 1.

²*Great Mental*, p. 80.

³*Great Mental*, p. 80.

⁴*Great Mental*, p. 83.

⁵*Great Mental*, p. 118.

⁶*Great Mental*, p. 118.

⁷Stephen Hawking, *Brief Answers To The Big Questions*, p. 188 olcker, pp. 105, 108.

⁸https://twitter.com/forexcom/status/1734932516530765933?s=43&t=e2gg_mw9oHxSyIF8_3iq2A

⁹https://twitter.com/thetranscript_/status/1736899167237403075?s=43&t=e2gg_mw9oHxSyIF8_3iq2A

¹⁰<https://data.bls.gov/timeseries/APU0000708111>